Simple? Maybe not.

Use caution with requests for third-party communications

By Steven M. Platau, JD, CPA, ABV

Late on a Friday afternoon, the long-time client calls.

"Can you send a letter to the _____ for me? This request just came up. They need a simple letter from you to complete their files for the transaction. Once you get this letter over to them, the transaction will close… and my business will make payroll today."

This kind of call makes a CPA wish for the days before telephones.

Whether the request is for something seemingly innocuous, such as a letter confirming that the CPA has been doing tax work for the client for X number of years, or something more challenging, such as "the client's net worth exceeds $X," letters to third parties are much more than a simple request. They carry an iceberg's weight in liability.

Client letter-writing requests come in many forms. The most basic is to confirm the client relationship, or that the CPA has prepared individual income-tax returns for the client. Somewhat more complicated is representing that money to be withdrawn from the business will not negatively impact enterprise equity, or that the entity likely will continue to make distributions of $X for the foreseeable future.

Really challenging is opining that the client is current on all its tax-filing obligations, or verifying that the client properly classifies individuals as employees; that equity is at least $X; or that all client employees are legal immigrants. Equally challenging is a reference letter to a financial institution in another country, despite the fact that it is customary in that country to obtain business references as part of commencing a banking relationship.

The risk in responding to these requests is significant. The requesting party, typically a financial institution, may tell clients these letters are routine. However, letter requests often are more sinister than customary.

Lawyers advising banks, bearing their employer/client's security interests in mind, devise credit policies designed to identify and collateralize as much security as they can get. In broadening that security net for the bank, attorneys often devise policies encouraging loan officers to trap CPAs into communicating directly with banks. This is not an exaggeration. These letter requests serve the bank lawyer's purpose by serving up an additional party with deep pockets to pursue in the event that there is a default. Without a direct communication from the CPA in the bank's files, bank lawyers often are frustrated in pursuing the CPA as an additional party to a loan-default recovery case.

Professional standards prohibit some letter responses under any conditions. Other responses may be permitted only if CPAs undertake certain procedures to comply with professional standards. And other responses, although not prohibited, may expose CPAs to liability from third-party recipients.

Adding insult to possible injury, clients almost always consider these letters a routine, no-fee accommodation the CPA should produce to the third party at a moment's notice. Smart CPAs who manage risk should disabuse clients of the notion that communicating with a third party is an accommodation to be expected.

The best policy is to refuse communication with a third party. The courts are full of cases driven by good intent gone bad, and client retention too often depends on CPAs meeting clients' needs, if not demands.

The balance of this article is devoted to the risks and standards that may impact a third-party communication.

Some requests seem easy.

"Please send a letter confirming to the bank that you have been my CPA for the past five years."

This communication appears to be an easy one with which to comply. The request is factual, the CPA has been doing tax returns for the past five years, and this has been a good client. What possible liability exposure might arise out of sending a simple letter to the bank? The answer lies in a developing body of Florida law.

In 1990, the Florida Supreme Court opened up third-party liability for CPAs in Florida. In *First Florida Banks, N.A. v. Max Mitchell*[1] the Florida high court allowed a bank to prevail in an action against a Tampa CPA who had communicated directly with bankers as part of a client's loan application. Upon the client's subsequent loan-payment default, the bank sued the CPA, seeking damages for having relied on the CPA's representations to the bank. After bank losses in the trial and appeals courts, the Florida Supreme Court (in holding for the bank) reasoned that the CPA knew who was using the CPA's work; knew the specific purpose for which the bank was using the work (granting a loan); and had communicated directly with the bank.

This groundbreaking case changed the landscape for CPAs, opening the door for banks and other third parties to press cases against them. Before1990, non-clients were not likely plaintiffs in actions against Florida CPAs. In the 20 succeeding years, third-party users increasingly have found Florida's courts to be friendly forums for recoveries against CPAs.

The link between third-party users (typically funding sources such as >>>

banks, factors, insurance companies and investors) is known as establishing privity with the CPA. The CPA does not want this link. Sending any kind of letter to a third party, even a letter that merely recites facts, opens the door to the third party establishing privity. Once that occurs, the CPA's potential exposure to loss expands if that third party suffers a loss in dealings with the client.

An exploration of why the bank needs this letter is in order. The bank probably has copies of the client's tax returns that include the CPA's name (if not signature), so the bank knows the CPA has been undertaking work for the client. If the bank cared to look, its own records likely include negotiated checks from the client to the CPA in payment for services.

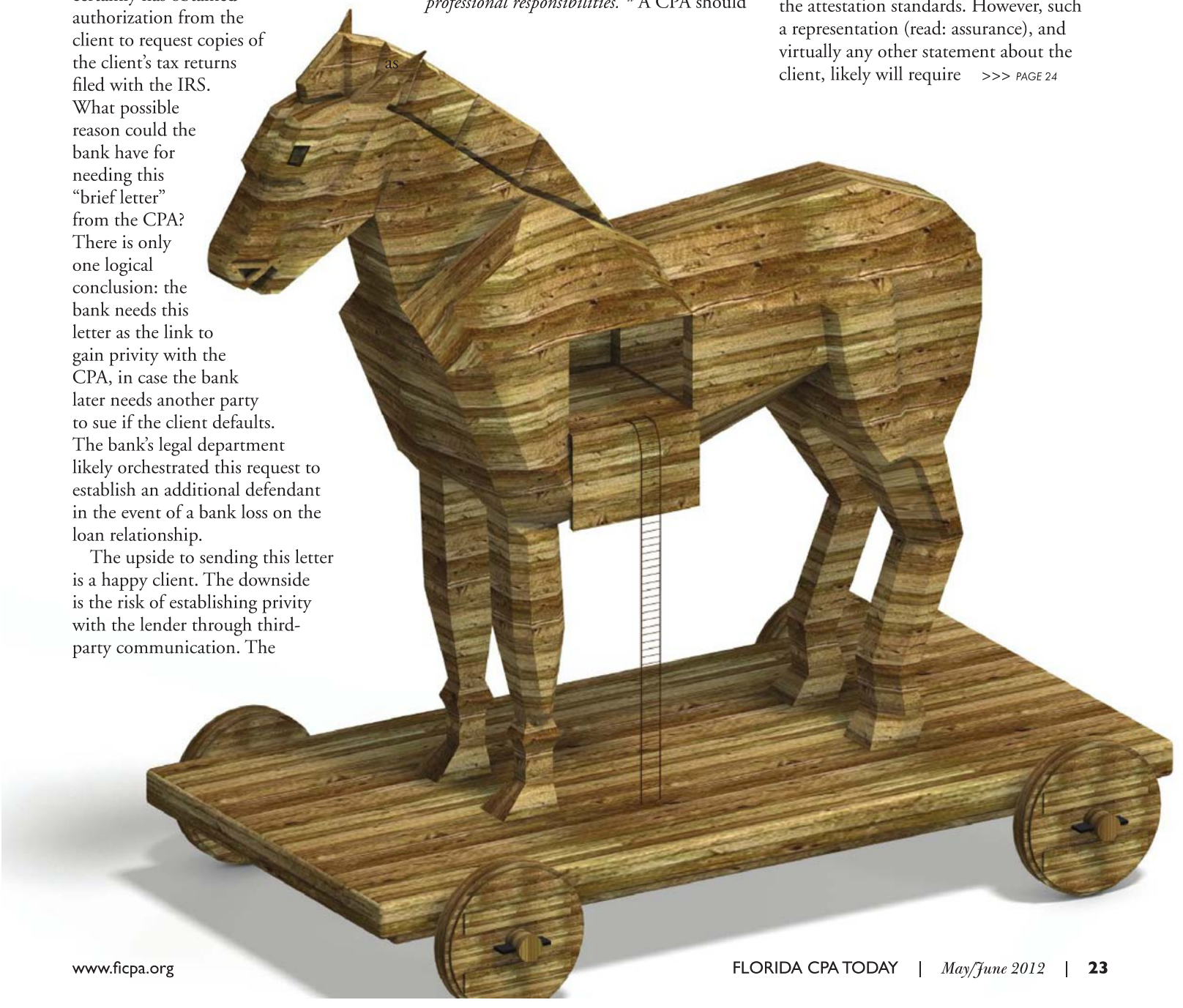
In any event, the bank almost certainly has obtained authorization from the client to request copies of the client's tax returns filed with the IRS. What possible reason could the bank have for needing this "brief letter" from the CPA? There is only one logical conclusion: the bank needs this letter as the link to gain privity with the CPA, in case the bank later needs another party to sue if the client defaults. The bank's legal department likely orchestrated this request to establish an additional defendant in the event of a bank loss on the loan relationship.

The upside to sending this letter is a happy client. The downside is the risk of establishing privity with the lender through third-party communication. The downside of electing not to respond is an unhappy client and/or the end of the client relationship.

Risk always is a consideration in deciding how to respond to these requests. CPAs must weigh the risk of client loss against the risk of litigation exposure in relation to a client's failed relationship with a third party. Some CPAs are willing to take the litigation risk. Others are more litigation-risk averse and elect not to respond. However, litigation risk is not the only risk CPAs face when deciding how to address letter requests.

Professional-standards breach is another risk for CPAs to consider in responding to letter requests. Professional standards governing all Florida CPAs require that: "*A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities.*"[xi] A CPA should consider if it is possible to maintain freedom from bias when he or she knows a third party effectively has been granted the opportunity to pursue him or her in a lawsuit if the client defaults. Some might suggest that sending such an innocent letter could be tied to a loss of objectivity – and, perhaps worse, also may indicate the practitioner's subordination of judgment.

It only makes sense that attestation of any kind requires an attestation engagement. Providing assurance to a third party about anything (even if the transmittal purports not to provide any assurance) requires that the CPA comply with Statements on Standards for Attestation Engagements. Few clients will be excited to hear that a letter to the bank confirming that a tax return containing a Schedule C will require compliance with the attestation standards. However, such a representation (read: assurance), and virtually any other statement about the client, likely will require >>> PAGE 24



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compliance with the standards. The North Carolina State Board of Accountancy twice has published cautions for North Carolina licensees about the necessity of complying with the standards.

A letter confirming that the CPA has prepared tax returns for the client seems like the most simple of requests. In all likelihood, the CPA probably prepared the returns and either sent them to the client for filing or, at the client's direction, electronically transmitted the returns to the IRS close to the time that the client authorized the filing. Interestingly, the bank portrays the request for a letter from the CPA as a mere formality, but the reality is much more sinister. It is rare today for a bank to have failed to secure customer authorization to obtain copies of returns – and sometimes, transcripts – directly from the IRS. They already know what has been reported. What the banker *really* wants is another defendant in the event the loan goes bad. And the person with a target on his or her back is the CPA.

Although confirming client relationships/duration and/or return preparation seems easy, it is not. CPAs should explain to their clients that the bank is doing nothing more than seeking an additional defendant, and that the CPA would be accepting additional exposure by sending such a letter.

A CPA might ask the client, "Does an engagement to prepare your tax return include exposure to bank-loan recovery efforts if you don't perform on the loan?" Watch the client's reaction very carefully. It may be very telling as to his or her character, possibly leading to a client-retention decision.

Others are more difficult...

A banker requests a letter from a CPA, stating that the down payment a business is making will not negatively impact the business. This request actually asks the CPA to express an opinion on client solvency. Professional standards prohibit CPAs from opining on solvency in any form of engagement.[iii] Accordingly, it would be unwise for a CPA to issue a letter providing any sort of assurance about a client's ability to pay bills as they come due.

Similarly, a letter from the CPA (even with some kind of qualifying language) suggesting that the client will continue to make distributions, or will remain current on its obligations, can be construed as a comment on client solvency[iv].

In either case, the CPA would be providing assurance to the third party, and would need to address the attestation-engagement requirements. Clients requesting what they perceive as a simple accommodation may not accept a requirement for a separate engagement to respond to a third-party request. However, under the professional standards, providing assurance of any sort to a third party would fall within the scope of the attestation standards.[v]

Letters asking for assurances about a client's financial stability put the CPA in a position of being asked to do something the professional standards prohibit. Although in some respects these more difficult letters may be easier to address, CPAs still cannot issue them.

Or most difficult.

Of special concern are requests for recommendation or introduction letters from U.S. clients preparing to do business in foreign countries. These letters are intended to have U.S. accounting firms endorse the integrity of their U.S. clients. Such arrangements may be common and/or customary in other countries. However, the freedom from bias required in all services rendered by U.S. CPAs does not permit CPAs to advocate for U.S. clients abroad.

When asked to recommend a U.S. client who does or plans to do business internationally, CPAs should consider a simple statement that U.S. standards do not permit references, and that the CPA firm has performed services and/or completed work for the client. Confirming the existence of a client relationship for a non-U.S. third party has not posed documented risks for U.S. CPA firms in the past.

During the past year, CPAs have received more unusual requests. The single most critical step a CPA must take, well before composing a letter or anything else that may be delivered to a third party, is this: always be sure to have written permission to divulge the existence of a client relationship.

A client's customer contacts the client, requesting that the client's CPA send the customer a letter confirming that the client's employees are properly classified in the U.S. The client thinks this is an easy request because the CPA completed an audit of the client's books. The CPA >>>

misses the point that this request requires a legal opinion, and probably would be considered the unlicensed practice of law.

Providing assurance about a client's net worth in the form of a simple letter is not wise. Professional standards identify several variations of assurance that can be provided in connection with personal financial statements.[vi] Should the client be inclined to retain the CPA to undertake a personal financial-statement engagement, presenting those statements contains a computation of net worth for the client, thereby providing the same information in a structured, more traditional form. In the "quick-call" situation, the client requests a simple letter, yet the CPA is required to offer a structured engagement for personal-financial statements. A quick letter to anyone regarding net worth is outside the purview of professional standards, and CPAs should be extremely careful in their responses.

Assurance about the client's tax or employment-classification treatment of employees and independent contractors is not appropriate for a simple letter to a third party. It would, however, be possible for the CPA to undertake an agreed-upon procedures engagement related to employee classification. The CPA also can perform tax research about a client's tax position. Although the tax-research letter would be addressed to the client, the agreed-upon procedures report could, at the client's sole discretion, be made available for third-party use.

Either situation would require substantially more work than a simple letter. In situations where the client is unwilling to engage the CPA to complete work in compliance with professional standards, sending a "simple letter" presents risks of running afoul of professional standards and regulatory statutes, and should be avoided.

Third-party communication requests are increasingly common, and come with varying levels of complexity and risk. CPAs should avoid the many third-party requests that, in compliance with professional standards, cannot be honored without additional procedures. All third-party communication requests carry the risk of establishing a precedent for third-party action, and CPAs should avoid them whenever possible.

In almost every situation, educating clients in advance about these requests, the costs of compliance and the risks to CPAs may go a long way in diffusing last-minute call requests. FCT

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Endnotes

[i] FIRST FLORIDA BANK, N.A., ETC., Petitioner, v. MAX MITCHELL & COMPANY, ET AL., Respondents, 558 So. 2d 9; 1990.
[ii] AICPA Professional Standards ET Section 55, Article IV.
[iii] AICPA Professional Standards AT Section 9101 Attest Engagements: Interpretations of Section 101 paragraph 23.
[iv] AICPA Professional Standards AT Section 9101 Attest Engagements: Interpretations of Section 101 paragraph 25.
[v] AICPA Professional Standards AT Section 101 Attest Engagements paragraph .01.
[vi] AICPA Professional Standards AR Sections 80 and 90 and Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 274-10-35-1.